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Improper Information Return Reporting Leads to Penalties and Loss of Deductions

Studies indicate that taxpayer compliance is highest when there is third party information reporting, such as the filing of Forms W-2 and 1099. As a result, we, in cooperation with the Employment Development Department (EDD), will devote greater resources to verify that your clients' business expense deductions for wages and compensation paid to employees and independent contractors are supported by Forms W-2 and 1099.¹ We may disallow deductions for unsupported wages and compensation, and either EDD or we may impose 9.3 percent penalties.^{2,3} We may also impose a \$50 penalty for each failure to file or furnish correct and timely Forms W-2 and 1099.⁴ EDD has a corresponding \$50 penalty for non-compliance with Form W-2 requirements.⁵ Finally, if the unsupported amounts result in a substantial understatement of income tax, your client could be subject to our 20 percent accuracy-related penalty.⁶

The failure to correctly and timely report wages and compensation contributes to the tax gap, which is the difference between what taxpayers owe and what they voluntarily pay. Our efforts to address the tax gap will help to ensure that business expense deductions are properly supported and that all income received by employees and independent contractors is properly reported.

By helping your clients to comply with these reporting requirements, you further assist our efforts to close the tax gap and level the playing field among all taxpayers.

For more information, go to ftb.ca.gov and search **information returns** or [FTB Pub 4227A, Guide to Information Returns Filed With California](#).

¹ California Revenue & Taxation Code (R&TC) Section 18631, Internal Revenue Code (IRC) Sections 6041 and 6041A, and California Unemployment Insurance Code (CUIC) Section 13050.

² R&TC Sections 17299.8 and 24447.

³ R&TC Sections 19175 and 17041 and CUIC Section 13052.5.

⁴ R&TC Section 19183 and IRC Sections 6721 and 6722.

⁵ CUIC Section 13052.

⁶ R&TC Section 19164 and IRC Section 6662.

Common Errors Found on California Combined Returns

We are seeing an up tick in errors on these returns. Beginning with taxable year 2007, we added two new questions to Side 1 of the California [Form 100](#) and [100W](#):

Question B-3: Is there a change in the members listed in Schedule R-7 from the prior year?

Question B-4: Enter the number of members (including parent or key corporation) listed in the Schedule R-7, Part I, subject to income or franchise tax.

During the 2007 filing season, we received many returns that did not respond to the above questions or provided the wrong information. For example, if an entity has not been assessed the franchise tax or the income tax as reported on Section A, Part I of the Schedule R-7, that entity should not be considered in the response to Question B-4.

Another area where common errors occur is on the [Schedule R-7](#). Boxes A, B, and C of Section A, Part I are not being checked. Boxes A and B on the Schedule R-7 should be checked based on the following:

- If the electing member is incorporated, organized, qualified, or registered with the California Secretary of State to do business here, this member has a California filing requirement since they are subject to the franchise tax. This electing member would check Box A.
- If the electing member has any property, payroll, or sales in California, this member has a California filing requirement since they are doing business here and are subject to the franchise tax. This electing member would check Box B.
- If the electing member derives income from sources within California, but is not doing business here, this member has a California filing requirement since they have California source income and are subject to the income tax. This electing member would also check Box B.

In addition, assigned California corporation numbers are not being provided.

Quite often, tax preparers and taxpayers list information in Section A, Part I of the Schedule R-7 with information from the federal consolidated return. A common error is that entities that are not California taxpayers are identified as such. Section A, Part I of the Schedule R-7 should only include entities that are required to file a return in California. If an entity does not have a California return filing requirement, the entity should be identified in Part 2 of the Schedule R-7.

Another area of concern involves the key corporation. Disclosing the key corporation's California corporation number is critical when identifying affiliates on the Schedule R-7.

The key corporation must file the single group return for all of the California taxpayers of the combined reporting group. Preferably, the parent corporation of the California taxpayers should

be designated as the key corporation, but only if it is qualified or incorporated in California, or if it is doing business in California, or if it has California source income. If the parent corporation is not taxable in California, the key corporation should be the taxpayer with the largest property factor numerator in California. All payments (including electronic fund transfers) must indicate the key corporation's California corporate number.

A properly completed California Schedule R-7 eliminates processing delays and reduces erroneous assessments. For more help, please consult [FTB Pub 1061](#), *Guidelines for Corporations Filing a Combined Report*.

Fewer Notices – Less Time FTB Revises Billing Process

As part of our ongoing effort to improve our collection program, we are streamlining the delinquent billing process. Effective July 1, 2009, the *Past Due Notice* and the *Delinquent Notice* will be eliminated, reducing the billing process by 90 days, giving taxpayers 105 days to resolve their tax liabilities. Eliminating these unnecessary notices brings us in line with the IRS' billing process, which gives taxpayers 90 days. The change will affect one in ten delinquent taxpayers.

We encourage taxpayers to pay what they owe as quickly as possible to avoid additional penalties, interest, and involuntary collection actions. Taxpayers who cannot pay their tax liabilities immediately can visit ftb.ca.gov and search **payment options** for more information including installment agreement requests or call the phone number listed on their notice.

We anticipate this change to accelerate our collection of revenue, increasing revenue by \$7 million in the 2009-2010 fiscal year. The change also reduces our costs by \$223,000.

Get Estimated Tax Payment Email Reminders

Tell your clients about our new estimated tax payment email reminder service and they will never forget an estimated tax payment due date. Subscribers will receive an email reminder to make their estimated tax payment approximately two weeks before each quarterly due date. Go to ftb.ca.gov and search for [MyFTB Account](#).

In addition, we value our taxpayers' feedback, so we added a survey feature upon logging out of MyFTB Account. Encourage your clients to give us their comments on new ways to improve MyFTB Account in the future.

Estimated Tax Payments with ABX3 3 Law Change

(Updated: April 9, 2009)

A taxpayer must make estimated tax payments if they expect to owe at least \$500 (\$250 if married/RDP filing separately) in tax for the 2009 tax year and they expect their withholding and credits to be less than 90 percent of the tax shown on their 2009 tax return or the tax shown on their 2008 tax return including alternative minimum tax.

If your client is required to make estimated tax payments, they are required to make installments of 30 percent of the required estimated tax liability for the first and second quarters and 20 percent of the required estimated tax liability for the third and fourth quarters. Before 2009, payments were made in four equal installments.

Increase to PIT tax rate and reduced dependent exemption credit

A taxpayer should also consider the effects of another recent law change⁷ when figuring estimated tax payments. The new law calls for an increase in each of the 2009 tax rates by an additional 0.25 percent and a reduction (-\$210) to dependent exemptions, adjusted for inflation. These changes will result in an increased tax liability. However, an under payment of estimated tax as a direct result of these changes to the tax rate and dependent exemption credit will not result in an underpayment penalty.

Married Filing Jointly with Two Dependents Example

Without the new tax rates/dependent exemption credit		With the new tax rates/dependent exemption credit	
Taxable Income	\$100,000	Taxable Income	\$100,000
Tax	*\$4,689	Tax	*\$4,689
		Taxable Income	\$100,000
		Increase in tax rate	X 0.0025
		Increase Tax	\$250
		Tax	*\$4,689
		Increase Tax	\$250
		Total	\$4,939
Exemptions Amount	(816)	Exemptions Amount	(396)
Total Tax	\$3,873	Total Tax	\$4,543

*Based on the 2008 tax table.

⁷ ABx3 3; Stats 2009, Ch. 18

Check Refund Status

Good news! The state is issuing tax refunds again. Our online service helps your clients know when they can expect to receive their refund. It also provides information about any offsets that may have reduced their refund amount. All that is needed is your client's social security number, mailing address, and refund amount.

Go to ftb.ca.gov and search for [refund status](#).

Paying Electronically Saves Time

We all know that going paperless saves time, hassle, and trees. Paying electronically means your client doesn't have to spend time writing and mailing a check. It also ensures that their payment is quickly applied to their account. We encourage them to use one of the many options we offer for electronic payments.

But which is right for them? We have provided you a brief summary of the options below. We also created an e-pay toolkit that contains posters, pamphlets, and other resources you can use to help your clients understand these options. Using the toolkit is another way to show your clients your commitment to making their lives easier. Go to ftb.ca.gov and search for **e-pay toolkit**.

Electronic Funds Withdrawal (EFW): Use this option to pay electronically when e-filing. Your client can pay when they e-file their balance due return, and not worry about having to remember to mail a check. They can choose the amount they want to pay, as well as the date they want the funds to be transferred from either their checking or savings account. Your clients can even schedule electronic withdrawal for their next year's estimated tax payments when they e-file. Check your software provider's instructions for the availability of this option.

Web Pay: Your clients can request a debit to their account online, at any time, to pay **any** FTB liability, including:

- A balance due on their current-year tax return.
- Extension payments (Form FTB 3519).
- Estimated tax payments (Form 540-ES).
- Prior-year amounts.
- Any bill.

Similar to EFW, your clients choose the amount to pay and the date the funds should be transferred from their checking or savings accounts.

To use Web Pay, all your clients need to enter are their social security number and last name.

Credit Card: Your clients can use their credit cards to pay **any** bill when they make a payment through Official Payments Corporation. Official Payments Corporation charges a convenience fee of 2.5 percent (minimum \$1).

Installment Payments: If your clients are unable to pay their balances in full, encourage them to apply for an installment agreement online. Generally, your clients qualify if they:

- Owe a balance of \$10,000 or less.
- Agree to pay their balance in 36 months or less.
- Have filed all personal income tax returns.

Online installment agreements are available for balances of \$10,000 or less. We also accept installment agreement applications for balances up to \$25,000, and for payment periods up to 60 months. However, taxpayers who owe balances between \$10,000 and \$25,000 should call **800.689.4776**, to discuss setting up an installment agreement.

Small Business

Do You Need to File a Claim for Refund?

If you filed your 2004 LLC tax return (Form 568) and paid a fee you may need to file a claim for refund for 2004. The time to request a refund is running out.

Before the enactment of Assembly Bill 198 (Stats. 2007, Ch. 381, effective on October 10, 2007, and operative for taxable years beginning on or after January 1, 2007), LLCs paid an annual fee based on the LLC's total income from all sources reportable to this state.

The constitutionality of the LLC fee under former California Revenue and Taxation Code Section 17942 has been challenged in three separate court cases:

Northwest Energetic Services, LLC v. Franchise Tax Board – The LLC in this case registered with the Secretary of State but did no business in California. The Court of Appeal held that assessing an LLC fee on an entity that had no income attributable to activities in California was unconstitutional and the fee should be refunded. This case is now final with respect to the constitutional issue.

Ventas Finance I, LLC v. Franchise Tax Board, Court of Appeal, First Appellate District, A116277, A117751 - The LLC in this case had income attributable to activities within and without California. A decision was issued but is not final.

Bakersfield Mall, LLC v. Franchise Tax Board, San Francisco Superior Court CGC-07-462728 - The LLC in this case alleges it conducted all of its activities in California. The case is ongoing.

If you filed an LLC tax return (form 568) and paid a fee based on worldwide total income, regardless of where that income was sourced, you may want to file a claim for refund. If you want to file a claim for refund, there is a time limit to request a refund known as the statute of limitations.⁸ Generally, you can file a refund claim four years from the due date of the return or one year from the date of overpayment which ever occurs later. For most LLCs, the statute of limitations to request a refund of any or all of their 2004 fee will expire on April 15, 2009.

If an LLC wants to file a refund claim based on recent court cases, the representative or LLC should fax a letter at **916.845.9796** with the following information:

- The LLC name and identification number issued by the Secretary of State. Unregistered LLCs use the identification number issued by the FTB.
- This is a claim for refund.
- The tax years involved.
- A description of the issue (stating that the LLC fee is unconstitutional is enough).
- The amount of the claim, which should match the amount of the annual fee that the LLC paid.
- Name of person to contact, phone number, and fax number.

The letter must be signed by a representative with a valid power of attorney or signed by the LLC's managing member.

We will provide a confirmation of the faxed refund claim receipt. The refund claim will be held pending result of the court's final decision on this issue. FTB cannot email information since the letter will contain confidential information.

Although we prefer a fax, you can send claims for refund for this issue by sending a letter or an amended return to the following address:

Franchise Tax Board
PO Box 942867
Sacramento CA 94267-8888

Because the decision in *Northwest* with respect to the LLC fee is final, we are processing refund claims for LLCs that have the same facts as were involved in the *Northwest* case, i.e., an LLC that conducted no activities in California. Both the *Ventas* and *Bakersfield* cases are still pending and action on claims for LLCs that have the same facts as were involved in either of these cases will be held pending the final court decision.

For more information, go to our website and search for [FTB Notice 2008-2](#).

New Jobs Tax Credit

A New Jobs Tax Credit is now available for employers beginning on or after January 1, 2009. The credit, which will be claimed on the 2009 tax return, is \$3000 for each additional full-time

⁸ California Revenue and Taxation Code Sections 19306, 19308, 19311, 19312, and 19313.

employee for small businesses with 20 or less employees. This credit will not be subject to the 50 percent limitation for business credits.

The total amount of the credit available to taxpayers will be capped at \$400 million. We will determine when the cap has been reached and will set a cut-off date for claiming the credit. The credit must be claimed on a timely filed original return received by us before the cut-off date. This cut-off date is defined as the last day of the calendar quarter within which we estimate the \$400 million limit will be reached. The cut-off date has not yet been determined.

Taxpayers claiming the credit after the cut-off date will be notified that the credit is denied. If the credit is denied because the cap has been reached, taxpayers will not be subject to the underpayment of estimated tax penalty or underpayment of tax penalty to the extent that the underpayment was created or increased by the disallowance of the credit.

An employer will qualify for the credit if:

- Each qualified full-time hourly employee is paid wages for not less than an average of 35 hours per week.
- Each qualified full-time employee that is a salaried employee was paid compensation during the year for full-time employment within the meaning of [Section 515 of the Labor Code](#).
- On the last day of the preceding taxable year, they employed a total of 20 or fewer employees.
- There is a net increase in qualified full-time employees compared to the number of full-time employees employed in the preceding taxable year. For taxpayers who first commence doing business in California during the taxable year, the number of qualified full-time employees employed in the preceding year would generally be zero, unless certain special rules apply.

An employer may not claim the credit for those employees who are any of the following:

- Certified as a qualified employee in an enterprise zone or targeted tax area.
- Certified as a qualified disadvantaged individual in a manufacturing enhancement area or a targeted tax area.
- Certified as a qualified disadvantaged individual or qualified displaced employee in a local agency military base recovery area.
- An employee whose wages are included in calculating any other credit allowed.

A new credit form is currently being developed and will be available by December 2009. For more information about this credit, go to ftb.ca.gov and search for [new jobs tax credit](#).

Ask the Advocate



In March, we implemented our new Systemic Issue Management System. This system allows us to collect taxpayer issues and track the research and resolution.

Robert, a CPA from LA, reported the following issue: Why are several of his clients with multiple W-2s being denied refunds of their excess State Disability Insurance (SDI) contributions?

Our staff looks at each W-2 to verify SDI withheld for each employer. This occurs whether the return was e-filed or filed on paper. For paper returns, sometimes there is a problem because the SDI amount is not clearly identified as SDI on each W-2. Instead, there is only a dollar amount present in box 14 of the W-2. To help alleviate this problem we trained our staff to look at the amounts appearing in box 14, regardless of the presence of an identifying abbreviation. Amounts present with no designator are compared to the current percentage equal to the SDI rate. If those amounts match, we verify the wages were claimed on the return and then allow the excess SDI.

For e-filed returns, because the physical W-2 is not attached, we must rely on the preparers input for each wage and tax statement (W-2) to verify SDI amounts. Tax preparers should look for the efile software prompt that asks the preparer to enter SDI information in Disability Plan Literal (Field 363) and to specify a **designator**. The **designator** identifies it as SDI or VPDI, etc., and places it on the wage and tax statement with the appropriate abbreviation. The e-filed W-2 is set up the same as paper with box 14 utilized for SDI, employees are trained to verify any amount entered in the field for SDI. With the presence of the designator, employees can more easily identify the amounts as SDI.

That being said, it looks as though both FTB and tax return preparers can work together to reduce or hopefully eliminate this problem (ok reduce). Thank you Robert for Asking the Advocate.

If you have a systemic issue or just want to check out the system, go to ftb.ca.gov and search for **systemic issues**. We will research the issue and take the appropriate actions.

Steve Sims, EA
Taxpayers' Rights Advocate

Inside FTB

- FTB Begins Annual Nonfiler Program

If you notice an increase in new clients who need to file overdue tax returns, it may be because we began contacting more than 900,000 individuals who earned California income, but failed to file state income tax returns last year.

Each year, we receive more than 350 million income records from third parties such as the IRS, banks, employers, state departments, and other sources. We match this information against the records of tax returns filed. Last year, we collected more than \$550 million in revenue through these efforts.

This effort is nothing new – since the 1950s, FTB has contacted individuals who may have a filing requirement, but have not filed a tax return. These individuals will have 30 days to file their state tax return or show why one is not due. When a required return is not filed, FTB issues a tax assessment using income records to estimate the amount of state tax due. The assessment will include interest, fees, and penalties.

- The *Package X* customer service phone number, 916.845.7070, discontinues on April 16, 2009.
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Criminal Corner

Former Vice President of Finance Pleads Guilty to Grand Theft, False State Income Tax Returns

A Chatsworth man pleaded guilty to one felony count of grand theft and one felony count of filing a false state income tax return.

James I. Ha, 35, was employed as the vice president of finance for a local marketing company. According to court documents, Ha abused his position of trust by embezzling more than \$350,000 from 2001 – 2004. In addition, Ha also failed to claim this money on his state income tax returns for the same years. All income is taxable including income from illegal sources. Ha used the embezzled funds for personal expenses.

Sentencing is delayed until April 2010, to give Ha time to pay restitution to his former employer and pay FTB more than \$45,000 representing the unpaid tax, penalties, interest, and the cost of the investigation. Ha faces up to three years in state prison and five years of formal probation.

Failing to report all income is part of the \$6.5 billion tax gap California faces each year. The tax gap is defined as the difference between the tax that is owed and the tax that is

paid. Since January, FTB has cooperated with local district attorneys around the state on six successful prosecutions.

Los Angeles County Superior Court Judge Marcelita V. Haynes presided over the case and Los Angeles County Deputy District Attorney Reid Rose prosecuted the case. This was a joint investigation between the Los Angeles County Police Department, the Los Angeles County District Attorney's Office, and us.

Restitution Ordered in Identity Theft, Online Auction House Scam

A Brentwood man was ordered to pay more than \$187,000 restitution to the State of California after previously pleading guilty to state income tax evasion.

Charles Merritt-Osborne is currently serving an eight-year prison term after pleading guilty in June 2008. Merritt-Osborne was the alleged ringleader of a scheme where stolen identities were used to create fraudulent companies, which then obtained credit to purchase goods for resale on eBay. The scam netted more than \$2 million.

Two felony counts of state income tax evasion were among the charges to which Merritt-Osborne pleaded guilty. An exact amount of restitution was not determined at sentencing, so the hearing ordered full restitution in the amount of \$187,191 which represents the unpaid tax, penalties, interest, and the cost of the investigation. All income is taxable including income from illegal sources. The failure to file tax returns is part of the \$6.5 billion tax gap California faces each year. The tax gap is defined as the difference between the tax that is owed and the tax that is paid.

Santa Clara Superior Court Judge David A. Cena ordered the restitution in Department 31 of the Hall of Justice. Assistant Attorney General Ralph Savilla with the Office of the Attorney General prosecuted the case. The fraud was discovered by the state's high tech crime task force.

Big Business

Large Corporate Understatement Penalty Frequently Asked Questions

In December 2008, we constructed a set of [frequently asked questions](#) (FAQs) to further explain the large corporate understatement penalty. The new penalty⁹ applies to corporations for taxable years beginning on or after January 1, 2003, where the corporation has an understatement of tax in excess of \$1 million. The penalty is 20 percent of the entire amount of the understatement. The understatement is measured by the difference between the tax reported on the original return or on an amended return, filed on or before the extended due date, and the correct tax liability.

⁹ California Revenue and Taxation Code section 19138(b).

For the purpose of this penalty for taxable years 2003-2007, a taxpayer can file an amended return and pay the tax shown on the amended return by May 31, 2009, to treat the tax shown on this amended return as tax shown on the original return. This will increase the self-assessed tax base against which the understatement is measured to reduce the likelihood of receiving this penalty.

Recently, we drafted an additional set of FAQs for the large corporate understatement penalty addressing procedures on the following subjects:

1. Filing of amended returns for pre-2008 taxable years.
2. Payment of amount shown on such amended returns.
3. Method to alleviate burden of filing such amended returns in the following situations:
 - Pending proposed assessments.
 - Disputed proposed assessments.
 - Final proposed assessments.

We held an Interested Parties Meeting on March 23, 2009 collecting your comments and recommendations regarding these purposed FAQs. This second draft of FAQs is designed to answer questions relating to the implementation and administration of the cure provision of this penalty. Stay tuned for the results.